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## **CHARITIES AND THE INDUSTRY COMMISSION**

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SANDRA RODMAN**

**SCHOOL OF ACCOUNTING LEGAL STUDIES  
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## SYNOPSIS

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On 27 October 1994 the Industry Commission handed down a draft report on its inquiry into charitable organisations. This article discusses the current taxation treatment of these organisations and the recommendations made by the Industry Commission in relation to their future taxation treatment.

## INTRODUCTION

On 27 October 1994 the Industry Commission (the Commission) handed down a draft report on its inquiry into charitable organisations. The Commission had spent nearly 12 months investigating community social welfare organisations<sup>1</sup> (CSWOs) including the appropriateness of the present taxation treatment of charitable organisations.

The draft report makes recommendations for the taxation of CSWOs including alterations to their exemption from sales tax, fringe benefits tax and other indirect taxes with alterations to the threshold of tax deductible gifts and range of organisations qualifying for public benevolent status.

This article examines the current taxation treatment for these organisations and the recommended changes made by the Industry Commission.

## EXEMPTION FROM INCOME TAX

### Current Taxation Treatment

Section 23<sup>2</sup> currently exempts from income tax (among other things) the income of charitable organisations.<sup>3</sup> The exemption only applies to "institutions" which are establishments, organisations or associations instituted for the promotion of some object. Therefore, for the income of a CSWO to be exempt under this section, it must be incorporated for the purpose of furthering charity.

Before a CSWO will be considered to have this purpose, it must be carried on predominantly or exclusively for furthering charity. If the CSWO satisfies the following conditions it will usually be considered to be carried on for that purpose:

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<sup>1</sup> CSWOs are charitable organisations providing relief of poverty and other services beneficial to the community.

<sup>2</sup> Income Tax Assessment Act.

<sup>3</sup> Sec 23(e) of the Income Tax Assessment Act.

- it is not carried on for the purpose of making a profit;
- its incorporation documents contain the charitable purpose as the object of the association and this purpose is followed in practice; and
- it is not for the benefit of only a narrow section of the community.

"Charitable" is not defined in the Act and therefore the common law definition is appropriate. There are four basic purposes which are considered to be "charitable" at law:

1. Relief of poverty: the relief must be provided for the benefit of persons in a particular class, not for the benefit of a particular poor person. It is not necessary that the persons who benefit be destitute;
2. Advancement of Education: associations formed for the purpose of increasing public knowledge, propagating education or for education in particular subjects will be charitable;
3. Advancement of Religion: to be charitable the religious institution must have a religious purpose and be of benefit to the community; and
4. Community Welfare: these associations must be formed for purposes beneficial to the community. Some examples of the objects of such associations are promoting vegetarianism, the protection of animals, the preservation of land and buildings of beauty or of historical interest and public radio stations.

From the above list of charities, the Industry Commission only considered organisations to relieve poverty and benefit the community (CSWOs). They did not consider organisations which advance education or religion.

Before an association with one of the above purposes will be considered to be a charitable institution, its objectives and activities must be for public benefit. This does not mean that the whole community must be able to benefit from the association's activities. It is sufficient if a section of the community, or a certain class of persons benefits as long as there is a significant number of possible beneficiaries and the quality which distinguishes beneficiaries from other members of the community is a quality which does not depend upon their relationship with a particular person.

In order to obtain the exemption, the CSWO has to make a written application to the Commissioner of Taxation.

## **Commission's Conclusions**

It was put to the Commission that this exemption from income tax for CSWOs should be reviewed as it provides them with an unfair advantage over other tax paying competitors. The Commission examined this claim and concluded that while CSWOs do enjoy some benefits from better cash flows as a result of not paying tax, the exemption from income tax did not necessarily lead to advantages for non-profit organisations. As a result of these conclusions the Commission decided not to recommend any changes to section 23. All those organisations which were concerned about losing their income tax exemption can now relax. However, it may be, as will be seen below, that they will lose some of their indirect tax exemptions. The conclusion of the Commission in relation to the income tax exemption for charities is to be commended.

## **DEDUCTIBILITY OF DONATIONS**

### **Current Taxation Treatment**

The second area the Commission examined was the deductibility of donations to charities. Currently there is an inconsistency between organisations which are eligible for income tax exemption and those where their donations are eligible for deductibility. While all charitable bodies are eligible for exemption from income tax, only those charities which are also classified as public benevolent institutions are also eligible for deductibility for their donations under sec 78.<sup>4</sup>

Section 78 specifically allows for the deductibility of non-testamentary gifts of \$2 or more made to a multitude of listed organisations such as public hospitals, public benevolent institutions etc. One group of organisations which satisfies the requirements of section 78 are "public benevolent institutions". A public benevolent institution is one which:

1. has as its object the relief of poverty, sickness, suffering, distress, misfortune, destitution or helplessness;
2. is carried on without the purpose of private gain for particular persons;
3. is established for the benefit of a section or class of the public;
4. the relief is available without discrimination to every member of that section of the public which the organisation aims to benefit;
5. the aid is given *directly* to those in need; and
6. any non-benevolent activities are minor and ancillary to the association's basic operation.

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<sup>4</sup> Taxpayers may also be eligible for deductions in relation to donations and gifts under sec 51(1) provided the gift was incurred in gaining or producing assessable income or was necessarily incurred in carrying on a business for that purpose.

The ATO has issued TD 93/11 which basically agrees with these requirements for an association to be a public benevolent institution. A CSWO applies to its local Australian Taxation Office (ATO) for recognition as a public benevolent institution under section 78. Currently, there is no ongoing process whereby the ATO reviews the status of the CSWO after the recognition is granted. The onus is on the CSWO to notify the ATO of any changes to the nature of the organisation.

### Commission's Conclusions

The Commission concluded that the tax deductibility of donations had a number of advantages which warranted the continuation of the system. However the Commission identified 5 concerns with the current system for the deductibility of donations.<sup>5</sup>

One of these concerns related to the inequity of the deduction due to its association with the progressive tax scale. This means both that the government's contribution varies according to the donor's marginal tax rate and that donors in higher tax brackets have greater incentives to donate. A number of options to overcome this inequity, including the use of rebates instead of deductions, were considered but the Commission did not make any draft recommendations in relation to this matter.

As explained before, a further problem identified by the Commission was the inconsistency that arises where some CSWOs receive tax deductions for donations while others do not. Under the current system, organisations will be eligible for deductibility of donations if:

1. they are a public benevolent institution;
2. they fall within one of the specified categories in sec 78 e.g. public hospitals; or
3. they have lobbied the government and are specifically listed in sec 78.

A public benevolent institution is basically an institution which provides *direct* relief for poverty, sickness, destitution etc. It does not include a wide range of indirect assistance in the nature of self-help or prevention. An example of the difference between public benevolent institutions and other CSWOs is found in TD 93/11:

A nonprofit organisation which promotes the health of women is charitable.<sup>6</sup> A nonprofit organisation which provides medical facilities to disadvantaged women who otherwise do not have access to these facilities is benevolent.<sup>7</sup>

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<sup>5</sup> Page 234 of the Commission's draft full report. The areas of concern identified by the Commission were the inequity when associated with the progressive system of income tax, the bias towards multi-service CSWOs, the inconsistency of some CSWOs receiving tax deductibility for donations while others do not, the absence of limits on donations and the inconsistency in tax treatment between donations of money and time.

<sup>6</sup> Therefore it is eligible for tax exemption but not deductibility of donations.

<sup>7</sup> Therefore possibly eligible for tax exemption and certainly eligible for deductibility of donations.

This effectively favours public benevolent institutions over other CSWOs which address community needs in less direct ways. As a result of these inconsistencies, the Commission recommended that the tax deductibility of donations should be retained, but that it should be extended to donations made to *all* CSWOs instead of just those which are public benevolent institutions.<sup>8</sup> This is a laudable and long overdue change.

The Commission felt that "the characteristics of a CSWO which is exempt from income tax and has tax deductibility would be:

- (a) its principal purpose is charitable (within the scope of the terms of reference);
- (b) it does not pay any of its profits or financial surplus, or give any of its property to its shareholders, members, beneficiaries, controllers or owners, as the case requires;
- (c) it has a public fund:
  - (i) to which gifts of money or property for its charitable purpose or purposes are to be made;
  - (ii) to which any interest on money in the fund is to be credited;
  - (iii) to which any money derived from the property given to the fund is to be paid;
  - (iv) that does not receive any other money or property; and
  - (v) that is used only to support the organisation's charitable purpose or purposes;
- (d) it has agreed to provide, for the public record, statistical data about gifts to that organisation during a specified period; and
- (e) it complies with any rules made from time to time by the Treasurer or by another relevant ministers to ensure that gifts to that organisation are used only to support its charitable purpose or purposes."<sup>9</sup>

Along with this recommendation came the recommendation from the Commission that the ATO should introduce a process of review of CSWOs receiving tax deductibility status and other tax benefits.<sup>10</sup> As a result of this recommendation it would be wise for all non-profit organisations to ensure their taxation affairs are in order before such a review commences. This would include such matters as ensuring evidence exists of a Section 23 (e) exemption, the organisation is listed on the current public benevolent institution lists available from the ATO regional offices, any alterations of objects or names have been approved by the ATO and that the formal constitution objects and principal activities of the organisation are internally consistent and in accordance with the income tax requirements.

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<sup>8</sup> Draft Recommendation 11.1 at p.239 of the Commission's draft full report.

<sup>9</sup> Page 241 of the Commission's draft full report.

<sup>10</sup> Draft Recommendation 11.2 at p.242 of the Commission's draft full report.

The final major matter the Commission dealt with in this area was the limit on the deductibility of donations. Currently all donations of \$2 or above to approved organisations are deductible. Unlike some countries, Australia does not impose an upper limit upon the deductibility of donations. However, the \$2 lower limit is imposing unreasonable costs upon some CSWOs who are required to issue receipts and maintain records in relation to the donation. In many instances it may cost them administratively to keep records of the donation almost as much as the donation itself.

The Commission recommended that the \$2 lower limit for donations be removed and the decision about which donations are to be treated as deductible be left to the individual CSWOs who are responsible for issuing receipts and keeping records.<sup>11</sup> This is an excellent recommendation and allows charities more freedom in relation to their record keeping requirements.

## **INPUT TAX EXEMPTIONS**

The Commission also examined the indirect tax exemptions available to CSWOs. Their examination dealt with sales tax, fringe benefits tax, land tax, stamp duties and bank charges, and concessions from rates and charges. The Commission collectively called these indirect taxes "input taxes".

### **Sales Tax**

Goods for use by many institutions including a public hospital, a non-profit hospital, a public benevolent institution or a public body established and maintained principally for the relief of unemployed persons are exempt from sales tax. Before it can be shown that goods are "for use" there must be an intention to use the goods in that way for a minimum period which is the shorter of two years or their effective working life. Generally goods to be onsold by the institution will not be eligible for the exemption. In addition to the purchase

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<sup>11</sup> Draft recommendation 11.3 of the Commission's draft full report.



of goods, the above institutions may also be exempt from sales tax in respect of leasing and hiring, goods used in repairs and goods used by contractors.

### **Fringe Benefits Tax (FBT)**

The major exemptions from FBT for charities relates to benefits provided in respect of the employment of employees of public benevolent institutions. To ensure that non-profit employers who are unable to claim a deduction for FBT were not disadvantaged by the 1 April 1994 changes to FBT, a rebate of FBT at the rate of 48% is available to tax exempt employers.

Currently, the use of salary packages exploiting the fringe benefits tax options is the only way that many CSWOs have of ensuring they can obtain quality staff as they do not have the ability to pay large cash salaries. The Commission was quite concerned with what they saw as exploitation of the FBT system by CSWOs who are able to provide after tax salary packages to their employees at a reduced cost compared with other employers.

The Commission believes it would be preferable for CSWOs to seek assistance from the government in order to attract quality staff rather than using the FBT system to do so and has made draft recommendation 11.5 recommending that the Commonwealth Government should remove the exemption from fringe benefits tax for public benevolent institutions. The recommendation is a major concern for charitable bodies who would be unlikely to obtain grants sufficient to pay the increased salary to maintain the employment of quality personnel at a senior level.

### **State Taxes**

The remaining taxes examined by the Commission are state government taxes. There are various exemptions varying from state to state available to CSWOs for these indirect taxes.

### **Commission's Conclusions**

The Commission identified a number of general concerns they had with input tax exemptions<sup>12</sup> apart from their previously outlined concerns with FBT. As a result of these concerns, the Commission recommended that the Council of Australian Governments should establish a working party to examine the practicability of introducing a revenue neutral package of assistance for CSWOs in order to replace input tax exemptions.<sup>13</sup>

As well, the Commission made draft recommendation 11.6 which recommended that the Council of Australian Governments should simplify and standardise the criteria for input tax benefits for CSWOs

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<sup>12</sup> Page 246 of the Commission's draft full report.

<sup>13</sup> Draft Recommendation 11.4 at p.253 of the Commission's draft full report.

with a view to reducing inconsistencies between taxes and across jurisdictions.

## **CAPITAL GAINS TAX**

The final tax matter the Commission considered was the CGT consequences of bequests to tax exempt bodies. Currently if an asset is bequeathed to a CSWO by will, the consequences are:

1. the taxpayer is denied a deduction for the donation as sec 78 does not apply to testamentary gifts; and
2. unlike other assets passed on by the deceased, assets bequeathed to a CSWO are subject to capital gains tax in the hands of the deceased.<sup>14</sup> This was designed to ensure the inherent capital gain did not escape the revenue net altogether as when the asset is later disposed by the CSWO it will not be subject to tax as the CSWO is a tax exempt body.

The Commission considered that sec 160Y provided a disincentive to individuals to bequeath assets to tax exempt bodies. They concluded this incentive should be removed by "allowing bequests to organisations to which gifts are tax deductible, to be exempt from capital gains tax".<sup>15</sup> By making this statement, the Commission seems to have overlooked the fact that sec 78 does not allow deductions for testamentary gifts. Draft recommendation 11.7 was made recommending that assets bequeathed to community social welfare organisations that enjoy tax deductibility status should be free from any capital gains tax liability. However, the Commission did not make a similar recommendation in relation to the removal of the requirement in sec 78 that gifts be non-testamentary in order to be deductible.

## **CONCLUSION**

The Commission appears to have thoroughly considered the taxation aspects of charitable bodies. Charities should be pleased that:

- their income will remain exempt;
- more of them will be eligible to have deductible donations;
- they can decide upon the low deduction limit for donations themselves; and
- capital gains tax will no longer be payable upon assets bequeathed to them.

Charities will be disappointed that the Commission has recommended the removal of all indirect taxation exemptions, especially fringe benefits tax. Further, it is a pity the Commission appears to have overlooked the section 78 requirement in relation to non-testamentary gifts in order to obtain

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<sup>14</sup> Section 160Y of the Income Tax Assessment Act.

<sup>15</sup> Page 265 of the Commission's draft full report.

deductions. It would have been better if they could have recommended the abolition of this requirement at the same time they recommended the abolition of capital gains tax upon assets bequeathed to tax exempt bodies.

All of the above changes will occur in a much more regulated and accountable market for charities and they can expect the ATO to take a much greater interest in their ongoing activities than ever before.